STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company	)	
	)	
	)	
Proposed General Increase in Water and Sewer Rates.(tariffs filed October 27, 2011)	)	Docket No. 11-0767
	)	
	)	

REPLY BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Staff of the Illinois Commerce Commission ("Staff"), by and through its undersigned counsel, pursuant to Section 200.800 of the Illinois Commerce Commission's ("Commission" or "ICC") Rules of Practice (83 Ill. Adm. Code 200.800), respectfully submits its Reply Brief in the instant proceeding.

I. INTRODUCTION

A. OVERVIEW

In this proceeding, the Commission is investigating the October 27, 2011, request for a proposed general increase in water and sewer rates pursuant to Article IX of the Illinois Public Utilities Act (the "Act" or "PUA"), 220 ILCS 5/9, filed by Illinois-American Water Company (the "Company" or "IAWC").

B. PROCEDURAL HISTORY

Initial Briefs ("IB") were filed on June 15, 2012 by the People of the State of Illinois *ex rel.* Lisa Madigan, Attorney General of the State of Illinois (the "AG"); United States Steel Corporation-Granite City Works ("U.S. Steel"), the University of Illinois,

Air Products and Chemical Company ("Air Products"), participated in this proceeding as the Illinois Industrial Water Consumers ("IIWC"), together with the Federal Executive Agencies ("FEA"), referred to collectively as ("IIWC/FEA"); the Cities of Champaign and Urbana, and the Villages of Savoy, St. Joseph, Sidney and Philo (the "Cities"); the Village of Bolingbrook ("Bolingbrook"); Staff; and IAWC. Some of the issues raised in the parties' initial briefs were addressed in Staff's Initial Brief and, in the interest of avoiding unnecessary duplication, Staff has not repeated every argument or response previously made in Staff's Initial Brief. Thus, the omission of a response to an argument that Staff previously addressed simply means that Staff stands on the position taken in Staff's Initial Brief.

C. TEST YEAR

IAWC proposed to use a future test year for the twelve months ending September 30, 2013 in this matter. No party objected to the use of this test year.

D. LEGAL STANDARD

All rates set by the Commission must be "just and reasonable" and any "unjust or unreasonable" rate is unlawful. In this regard, Section 5/9-101 of the Public Utilities Act ("PUA" or "Act") provides, in relevant part, that:

> All rates or other charges made, demanded or received by any product or commodity furnished or to be furnished or for any service rendered or to be rendered shall be just and reasonable. Every unjust or unreasonable charge made, demanded or received for such product or commodity or service is hereby prohibited and declared unlawful. All rules and regulations made by a public utility affecting or pertaining to its charges to the public shall be just and reasonable. (220 ILCS 5/9-101)

II. RATE BASE

A. INTRODUCTION

Schedules showing the Company's rate base at present and recommended rates for the test year ending September 30, 2013 were presented by Company and Staff witnesses. Staff proposed a number of adjustments to the Company's proposed rate base in testimony and in its Initial Brief and continues to recommend that the Commission adopt the adjustments as listed below.

B. CONTESTED ISSUES

1. Pension Asset Adjustment

The Company continues to erroneously rely on its interpretation of prior Commission orders, advocating that since the Commission requires a rate base deduction if pension expense amounts exceed contributions, then the converse conclusion must be the logical, fair conclusion in this case. (IAWC IB, pp. 19-20) Staff has demonstrated how the Company's logic fails in light of past Commission decisions. (Staff IB, p. 8; see also AG IB p. 7) The Company further argues its theory that shareholders and bondholders will fund the level of IAWC's pension contributions which it will not recover from ratepayers. (IAWC IB, p. 21) Staff notes that this theory has been rejected by the Court. (Staff IB, p. 10, *citing People ex rel. Madigan v. Illinois Commerce Commission,* 2011 IL App (1st), 100654, 958 N.E.2d 405, 421, 426 (2011).)

In its Initial Brief, the Company accuses Staff of relying on too narrow an interpretation of past Commission orders. (IAWC IB, p. 22) Yet, the Company itself attempts to frame the issue by the very specific narrow inputs that created its pension asset, rather than by the general premise laid out by several Commission orders that

shareholders receive cost recovery in the revenue requirement only if it is demonstrated that they funded the asset. (Staff IB, pp. 8-9; AG IB, p. 7) Further, as the AG states in its initial brief, the Company's argument that it should receive cost recovery for pension payments in excess of the expense in "base rates" is inconsistent with basic test year principles. (AG IB, p. 6) Thus, the AG rightly supports the updated, net adjustment of Staff to remove IAWC's proposed pension asset from rate base. (*Id.*, p. 8)

2. Business Transformation ("BT") Costs Adjustment

Despite the AG's arguments to the contrary, IAWC has reflected in the test year estimated cost savings that will occur due to implementation of its new computer systems and reduced Service Company management fees due to non-regulated affiliates' use of the BT system. (Staff IB, p. 11)

In its Initial Brief, the AG raises for the first time a new concern, arguing that the Company is not authorized by its Services Agreement to include the BT costs in rate base. (AG IB, pp. 11-14) Staff found that the Company has reflected retirement of its old computer systems that the BT program will replace. (Staff IB, p. 12) Further, the Company discusses the BT project as a replacement of its former systems. (IAWC IB, p. 11) Therefore, the Company has included its information technology ("IT") costs, which also were provided by an affiliate, in rate base in the past. (*Id.*) Staff notes that the Services Agreement is silent with respect to facilities and rate base. (AG Cross Ex. 3) However, the historical presentation of the Company's prior IT systems is telling. In this proceeding, the Commission has the authority under Section 7-101 of the Act to approve the affiliated interest costs. Simply because the Company has yet to express

its application of such statute in its case is not controlling. Further, the AG provides no workable solution, as its allegation that the BT charges should somehow have only been charged to IAWC as expense amounts through service company billings has not been quantified in the record. It is clear, though, that charging such costs to ratepayers in a large lump sum in the test year, rather that ratably through capitalized costs, would increase the cost of service substantially. For all these reasons, the BT costs, as appropriately updated by the Company and adjusted by Staff, should be approved by the Commission.

3. Cash Working Capital

Pension Expense

The Commission should adopt Staff's calculation of cash working capital ("CWC"), including Staff's inclusion of pension expense at the amount included in the revenue requirement rather than the Company's proposal to use its projected qualified pension contribution. (Staff Ex. 1.0, p. 8) Staff's calculation of CWC is presented in its Initial Brief on page 10 of Appendix A for each service area.

Staff's initial brief enumerated five reasons demonstrating that the Company's proposal to use projected qualified pension contribution in the calculation of CWC is in error. (Staff IB, pp. 15-16) Those reasons continue to be valid.

The Company argues that Staff's position should be rejected because it ignores the amount of cash that IAWC actually expects to contribute to its pension trust. (IAWC IB, p. 27) The Company conveniently ignores the fact that its proposal would require the Commission to investigate each CWC component to determine if there is some

different actual cash disbursement amount that could be used instead of the revenue requirement amount. Asking the Commission to analyze each component of CWC to determine if the Commission should use alternates to the amounts presented in the revenue requirement is impractical, inefficient and should be rejected. (Staff IB, pp. 16-17)

The Company also conveniently ignores that in the instant proceeding, both Staff and the Company use Federal income taxes from the revenue requirement in their CWC calculations instead of actual cash disbursements. If the Commission were to adopt the Company's position, the Commission would have to adopt a similar approach with income taxes. The Company uses Federal income tax of $19,218,517 in its CWC calculation while the actual cash disbursement is $0. (Staff IB, p. 17) The Company failed to address this point in its Initial Brief.

The Company suggests that the pension contribution should be included in the CWC calculation because purchased water and sewer expenses, which are excluded from the revenue requirement, are included in the CWC calculation. These items are not similar. It is appropriate to include purchased water and wastewater treatment expenses in the CWC calculation because these items would be included in the revenue requirement if they were not excluded because they are recovered through a rider. The same is not true tor the pension contribution. Pension contributions are not included in the revenue requirement because they are not operating expenses; not because they are recovered through a rider instead. (Staff Ex. 9.0-C, p. 7)

The Company makes a misleading statement when arguing that their proposal is not overly complicated. The Company states that if the Company does not make, or does not expect to make, pension contributions in the test year, the cash working capital amount would simply be zero. (IAWC IB, p. 28) The Company's argument is valid only if the contribution amount was exactly zero. Logically, if the pension fund had gains beyond the required contribution, the Commission would be required to determine if the CWC calculation should include some negative amount for pensions.

Current and Deferred Income Taxes

The Company is incorrect when it states that the use of zero lag days is appropriate for determining the expense lead associated with deferred income taxes. (IAWC IB, p. 36) Staff's proposal for the treatment of current and deferred income taxes better represents the Company's CWC. Staff's CWC calculation includes current income taxes combined with deferred income taxes which represent a benefit to the Company attributable to the current period. Finally, the Company characterizes Staff's position on CWC as "sudden," as if Staff had ambushed it with a new position. (IAWC IB, p, 35) Staff wonders what the Company thinks is sudden about a CWC calculation that has been on file since April 26, 2012; twelve days before the Company's May 8 and 9, 2012 surrebuttal filing dates and fifty-five days before the Company's June 20, 2012 cross examination of Staff witness Kahle. The Company had ample opportunity to investigate and/or rebut Staff's position on this matter.

4. ADIT – Repairs Deduction

Staff continues to recommend that the Commission adopt Mr. Smith's adjustment to ADIT related to the Company's change of method for accounting for repairs for tax purposes. (AG Ex. 2.0, p. 57)

The Company's Initial Brief is mainly a reiteration of testimony by its witness James I. Warren, leaving little from which to reply. Staff maintains its position as stated in Staff's Initial Brief and supported in Staff testimony: the FIN 48 amount represents a source of cost free capital that should be reflected as a rate base deduction and the Commission may take notice of Federal Energy Regulatory Commission ("FERC") guidance on this issue. (Staff Ex. 9.0-C, pp. 10-13; Staff IB, p. 18-19)

C. RECOMMENDED RATE BASE

Staff's recommended rate bases for Illinois-American's respective rate areas/Districts have not changed and are reflected in Appendix A attached to the Staff IB.

III. OPERATING REVENUES AND EXPENSES

A. INTRODUCTION

Schedules showing the operating revenues, expenses and income at present and recommended rates for the future test year were presented by Company and Staff witnesses. Staff proposed a number of adjustments to IAWC's operating statements.

B. CONTESTED ISSUES

1. Rate Case Expense

Staff continues to recommend that the Commission approve Staff's adjustments to reflect a reasonable amount of rate case expense, $2,541,052, to prepare and litigate the current rate case filing. The difference between the Company's projected rate case expense and Staff's recommended amount is due to Staff's disallowance of certain costs of consultants engaged by the Company. The Company contests the following Staff adjustments: (1) disallowance of SFIO Consulting, Inc ("SFIO") consultant costs, (2) limiting a rebuttal consultant's hourly rate, and (3) disallowance of cost of consultants not yet engaged. (IAWC IB, p. 53)

Disallowance of SFIO Consultant Costs

As documented in Staff's Initial Brief, the Company has failed to provide the necessary support to enable the Commission to assess the just and reasonableness of SFIO's consulting expenses. (Staff IB, pp. 24-25) The Company has not provided any proof that the services SFIO is to perform are not duplicative and redundant of Company management and legal counsel responsibilities. The Company relies upon the provision of a contract with SFIO, in which the scope of services was redacted, and invoices with only the most generic description of services rendered as "tangible" evidence of the value of services rendered by SFIO. (IAWC IB, p. 55) Staff maintains that the Commission cannot rely on such vague documentation to find that the contracted costs of such services are just and reasonable rate case expenses as Section 9-229 requires.

Limiting Rebuttal Consultant's Hourly Rate

The Company's interpretation that the Commission cannot determine the just and reasonable hourly rate of an attorney or technical expert must be rejected. (IAWC IB, p. 56) Section 9-229 requires a finding that such costs are just and reasonable. Costs are a function of the contracted services, whether a flat amount for the engagement or an hourly rate. As the Commission found in Commonwealth Edison Company's ("ComEd") last general rate case, "A specific assessment of, and finding of, justness and reasonableness entails much more than approving an item that is generally included in rates. Otherwise, Section 9-229 would be meaningless." (Order, Docket No. 10-0467, May 24, 2011, p. 83) Therefore, costs cannot be adequately analyzed without consideration of the hourly rate.

Staff continues to recommend limiting the hourly rate for the Company's rebuttal consultant, James Warren. Mr. Warren's hourly rate is in excess of a reasonable hourly rate for the services to be provided. Mr. Warren's hourly rate is significantly higher than any of the hourly rates of external attorneys and external technical experts participating in the current rate case. (Staff IB, p. 25) Mr. Warren was retained to address tax issues related to FIN 48 and other tax related adjustments proposed by AG witness Ralph Smith. The Company claims to have hired Mr. Warren because of his education, expertise as an attorney and CPA, and his years of experience. (IAWC IB, p. 57) Similarly, the AG hired their expert Mr. Smith because of his education, expertise as an attorney and CPA and his years of experience, however, with an hourly rate nearly *four times less* than Mr. Warren's discounted hourly rate. While the tax issues in question are complex and require specialized knowledge, a practicing CPA would and should have such knowledge. Mr. Warren's hourly rate should be limited to the rate charged by

the Quality Control Partner from the CPA firm of Kerber, Eck and Braeckel, which reviewed the Company's projected financial statements used in the current rate case. This rate serves as a good example of a reasonable rate for a practicing CPA. (Staff IB, p. 25)

Disallowance of Cost of Consultants Not Yet Engaged

Staff limited the Company's recovery of rate case expense for rebuttal consultants to those consultants engaged at the time of the Company's rebuttal filing. (Staff Ex. 16.0 Supplemental (Rev.), Schedule 16.1 Update (Confidential), p. 4) The Company's projected rate case expense included estimates, albeit not quantified nor identified by consultant, for late-engaged experts in light of issues expected to be raised by Staff or intervening parties during the latter stages of the current rate case. To date, no late-engaged experts have been utilized by the Company. The Company has not provided any support for the costs of late-engaged experts, rendering it impossible to assess the just and reasonableness of such costs. Staff's adjustment to disallow the costs of consultants not yet engaged is appropriate and should be adopted by the Commission.

Amortization vs. Normalization of Rate Case Expense

Staff concurs with the Company's criticism of the AG's position to normalize, rather than amortize rate case expense. (IAWC IB, pp. 60-61) The AG's position has been considered and rejected repeatedly by this Commission, as indicated in the last general rate case Order in ComEd: "The Commission declines to "normalize" ComEd's rate case expense." (Order, Docket No. 10-0467, May 24, 2011, p. 68) The AG has presented no evidence to change Commission practice on this issue.

C. RECOMMENDED OPERATING INCOME AND REVENUE REQUIREMENT

Staff's recommended operating income and revenue requirement for Illinois-American's respective rate areas/Districts have not changed and are reflected in Appendix A attached to the Staff IB.

IV. COST OF CAPITAL

Staff witness Janis Freetly recommended an overall cost of capital of 7.39% for IAWC.[1] Under the traditional regulatory model, ratepayer and shareholder interests are balanced when the Commission authorizes a rate of return on rate base equal to the public utility's overall cost of capital, as long as that overall cost of capital is not unnecessarily expensive. If the authorized rate of return on rate base exceeds the overall cost of capital, then ratepayers bear the burden of excessive prices. Ratepayer interests are served best when the authorized rate of return on rate base equals the utility's overall cost of capital.

A. CAPITAL STRUCTURE

Ms. Freetly proposed using an imputed capital structure that contains 1.30% short-term debt, 56.70% long-term debt, and 42% common equity. (Staff Ex. 6.0, p. 9) In contrast, IAWC's forecasted capital structure for the test year ended September 30, 2013, including Staff's adjusted balance of short-term debt, would be comprised of 1.30% short-term debt, 48.68% long-term debt, and 50.02% common equity. The Commission should not determine the overall rate of return from a utility's actual capital

[1] Staff Ex. 14.0, Schedule 14.1 – REVISED.

structure if the Commission concludes that capital structure adversely affects the overall cost of capital.

Staff's proposed capital structure for IAWC imputes the September 30, 2011 equity ratio of parent company American Water Works ("AWW"), 42.00% for IAWC's average 2013 common equity ratio. Ms. Freetly used the actual proportion of short-term debt in the Company's forecasted average 2013 capital structure. To calculate the balance of short-term debt, she first calculated the monthly ending net balance of short-term debt outstanding from September 2012 through September 2013. The net balance of short-term debt equals the monthly ending gross balance of short-term debt outstanding minus the corresponding monthly ending balance of construction-work-in-progress ("CWIP") accruing an allowance for funds used during construction ("AFUDC") times the lesser of the ratio of short-term debt to total CWIP for the corresponding month or one. That adjustment recognizes the Commission's formula for calculating AFUDC which assumes short-term debt is the first source of funds financing CWIP and addresses the double-counting concern the Commission raised in a previous Order.[2] Next, she calculated the twelve monthly averages from the adjusted monthly ending balances of short-term debt and then averaged the twelve monthly balances of short-term debt for October 2012 through September 2013. (Staff Ex. 6.0 Sched. 6.2) Finally, Ms. Freetly added $8,406,022 to that balance to recognize that IAWC's actual short-term debt balances have exceeded the Company's projections by that amount on average over the period from May 2009 through December 2011. Hence, Staff recommends a short-term debt balance of $10,493,865. (Staff Ex. 6.0, pp. 4-5)

[2] Order, Docket No. 95-0076, December 20, 1995, p. 51.

To calculate IAWC's long-term debt ratio, Ms. Freetly added her average 2013 short-term debt ratio and the imputed 42.0% common equity ratio (1.30% + 42.00% = 43.30%) and then subtracted that from 100% to derive the long-term debt ratio of 56.70% (100% - 43.30% = 56.70%).

1. The Company's Proposed Capital Structure Violates Section 9-230 of the Act

The threshold question is whether IAWC's proposed capital structure is lawful in light of Section 9-230 of the Public Utilities Act. The fundamental flaw in IAWC's proposed capital structure is that its common equity ratio is 8 percentage points higher than that of its parent company, AWW. Even though Staff raised the issue in its direct testimony, IAWC did not demonstrate that the utility's operating risk is sufficiently higher to justify that differential or establish that its higher common equity ratio would not produce a rate of return in violation of Section 9-230. (Staff Ex. 6.0, p. 8)

IAWC's proposed capital structure is needlessly expensive due to an excessive amount of equity. The Illinois courts have clearly explained, "equity is a more expensive form of capital than debt." *Illinois Bell Telephone Co. v. Illinois Commerce Comm'n*, 283 Ill. App. 3d 188, 204, 669 N.E.2d 919, 931 (2nd Dist. 1996)("*IBT*"). Consequently, the "more equity in a utility's capital structure, the higher the ROR must be to recover the cost of capital." *Id*. *See also Citizens Utility Board v. Illinois Commerce Comm'n*, 276 Ill. App. 3d 730, 744 (First Dist. 1995)("*CUB*")("[S]ince equity always costs more than debt, as a corporation increases its proportion of equity, its total cost of capital generally increases, although the cost of debt and the cost of equity both decrease.").

As Staff noted in its Initial Brief, the Court in *CUB* acknowledged the natural incentive for a utility to avoid an "optimal, lowest cost capital structure" in a holding company context:

> When a larger corporation owns a utility, the corporation is generally motivated not to establish an optimal, lowest cost capital structure for the utility, but to use instead a structure with a greater percentage of equity than is optimal, thereby allowing the corporation to realize a greater return. The assured profits from the regulated utility can then bolster the security of the corporation, allowing it to sell its own debt instruments at lower cost and use the debt capital to finance riskier, unregulated and competitive ventures. Thus, the corporation maintains an overall capital structure with a higher proportion of low-cost debt, while reporting the capital structure of the owned utility with a higher proportion of high-cost equity. The Commission acknowledged the evidence showing that corporations which own utilities have this incentive to overstate the effective equity in the capital structures of the utilities, saying: "There is no question that a capital structure may be manipulated."

CUB, 276 Ill. App. 3d 730 at 745. Moreover, the Court recognized the Commission's duty to consider whether it was presented with such an "optimal, lowest cost capital structure," and the related burden on a utility to address the possibility of meeting its capital needs at lower cost in demonstrating the reasonableness of its capital structure:

> [T]he Commission should disallow recovery of any cost of capital in excess of that reasonably necessary for the provision of services. If a utility has included excessive equity in its capital structure, it has inflated the rate of return and its capital cost. While the Commission here found that Centel's reported capital structure was reasonable, it also ordered Centel to perform studies to determine whether a different capital structure could reduce capital costs. As Centel conceded at oral argument, *the order shows that the Commission found a reasonable likelihood that a different capital structure would permit Centel to meet its capital needs at lower cost. But this means Centel did not meet its burden of proving that the reported capital structure reflects capital costs reasonably necessary for the provision of services. The order contradicts the finding that Centel proved its proposed capital costs reasonable.*
>
> The order shows that the Commission based its approval of the capital structure primarily on its rejection of the evidence of manipulation CUB

> presented. Again, the Commission apparently acted as an impartial arbiter deciding which party presented the stronger argument. "Requiring intervenors to establish unreasonableness is *** no substitute for requiring proof of reasonableness." CUB's failure to prove manipulation of the capital structure is not sufficient to show that the reported capital structure provides an adequate basis for assessing Centel's cost of capital.
>
> *Id*., at 746-47 (emphasis added, citations omitted).

As the Staff noted in its Initial Brief, Staff IB, at 31-33, Section 9-230 provides in relevant part that:

> In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission *shall not* include *any* (i) incremental risk, [or] (ii) increased cost of capital … which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies.
>
> 220 ILCS 5/9-230 (emphasis added).

Illinois courts have interpreted this provision strictly against the inclusion of any incremental risk or increased cost of capital in a utility's rate of return, if such incremental risk or increased cost of capital results from association with unregulated affiliates. In *IBT*, 283 Ill. App. 3d 188, 669 N.E.2d 919, the Appellate Court for the Second District ruled that:

> *Section 9-230 does not allow the Commission to consider what portion of a utility's increased risk or cost of capital caused by affiliation is "reasonable" and therefore should be born by the utility's ratepayers; the legislature has determined that any increase whatsoever must be excluded from the ROR determination*. It is impermissible for the Commission to substitute its reasonableness standard for the legislature's absolute standard. The Commission may not define a portion of the Act in a way that conflicts with a specific directive contained in the Act. [citation] *We hold that if a utility's exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR calculation*.

> *IBT*, 283 Ill. App. 3d at 207, 669 N.E.2d at 933 (emphasis added; citation omitted).

Two things are apparent from this holding. *First*, the Commission cannot consider the reasonableness of a proposed capital structure until it makes a threshold determination that the capital structure in question satisfies the requirements of Section 9-230. *Second*, Section 9-230 absolutely bars, as a matter of law, the adoption of a capital structure which, as a result of affiliation, results in increased risk or increased cost of capital. Section 9-230 is designed to preclude parent companies from realizing greater returns from ratepayers by proposing a capital structure with a greater percentage of common equity at the utility level.

These findings are fatal to IAWC's proposal. Since equity is a more expensive form of capital than debt, a greater percentage of equity in a utility's capital structure equates to a higher rate of return. *IBT*, 283 Ill. App. 3d at 204, 669 N.E.2d at 931. Moreover, IAWC has an incentive to use a capital structure with an excessive amount of equity, which would then allow AWW a greater return on its capital, while leaving ratepayers to shoulder the costs. Since a company with less business risk can carry a lower percentage of equity on its balance sheet than a company with greater business risk, Staff asked that the Company demonstrate that IAWC has higher risk than AWW to justify the higher common equity ratio for the utility. However, the Company failed to quantitatively demonstrate that IAWC has significantly more operating risk than AWW and therefore has not justified the need for the higher common equity ratio for ratemaking at IAWC and failed to meet its burden pursuant to Section 9-230 of the Act.

The Company claims that Staff's imputed capital structure violates Section 9-230 of the Act because it adds debt which thereby increases the level of financial risk faced by the utility. Specifically, IAWC argues that imputing AWW's more highly-leveraged capital structure imposes greater financial risk to IAWC. (IAWC IB, pp. 67-70) Staff conducted a principal components analysis using IAWC's pro-forma ratios to reflect Staff's proposed 42% imputed equity ratio to ensure that the Water and Utility samples are comparable to IAWC with a lower equity ratio, and therefore higher leverage. This analysis indicated that the financial risk of IAWC was greater than both of Staff's samples and verified that increasing the financial leverage does not affect operating risk. Staff then adjusted the cost of common equity to reflect the higher financial risk that results from imputing a 42% equity ratio.

IAWC further argues that IAWC's risk profile decreases as the Company increases its common equity ratio which will result in economic benefits in the form of lower debt and equity costs. (IAWC IB, p. 73) Conversely, the Company argues that Staff's imputed capital structure results in increased leverage at IAWC, which would lead to significant increases to IAWC's financing costs. (IAWC IB, p. 74) As Staff explained in the Initial Brief at page 33, IAWC is already paying the debt financing costs that reflect the higher leverage of AWW, since the rating of the financing affiliate (American Water Capital Corp.) reflects the consolidated credit quality of AWW.

Even with higher financial leverage resulting from Staff's imputed capital structure, IAWC's rate of return is lower than it would be with a 50% common equity ratio. As explained above, IAWC's cost of debt would not change since it reflects

AWW's financial leverage, not IAWC's financial leverage. As can be seen below, using IAWC's proposed 50.51% common equity ratio and Staff's cost of common equity results in a 7.64% weighted average cost of capital. However, using Staff's imputed 42% common equity ratio and Staff's cost of common equity adjusted upward to reflect the higher financial risk results in a 7.39% weighted average cost of capital.

Company Proposed Capital Structure			
	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	1.30%	0.52%	0.01%
Long-term Debt	48.19%	6.04%	2.91%
Common Equity	50.51%	9.35%	4.72%
Total Capital	100.00%		
Weighted Average Cost of Capital			**7.64%**
Staff Proposed Capital Structure			
	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	1.30%	0.52%	0.01%
Long-term Debt	56.70%	6.04%	3.42%

Common Equity	42.00%	9.42%	3.96%
Total Capital	100.00%		
Weighted Average Cost of Capital			**7.39%**

When income taxes are considered, the rate of return on common equity would have to rise to 10.48% for the rate of return on rate base reflecting a 42% common equity ratio to rise to the level of the rate of return on rate base reflecting a 50.51% common equity ratio.[3]

B. Cost of Common Equity

IAWC suggests that the Commission leave the return on equity at 10.38%, as authorized in Docket No. 09-0319. (IAWC IB, p. 77) The Company states that any return on equity below IAWC's current authorized return of 10.38% is unreasonable and could impair the ability of IAWC to attract the capital necessary to fulfill its planned investment needs. (IAWC IB, p. 80) However, since the Commission Order was issued in Docket No. 09-0319, on April 30, 2010, market capital costs have declined. In fact, market information suggests that IAWC's current market cost of equity is much lower than its last authorized return on equity. (IIWC/FEA Ex. 1.0, pp. 3-8) This decline was recognized by IAWC cost of equity witness, Ms. Ahern, who lowered her recommended return on equity from 12.28% in Docket No. 09-0319 to 11.40% in this case. (IIWC/FEA

[3] This calculation applies a 1.61 gross revenue conversion factor to the weighted cost of common equity. (See Staff Initial Brief, Appendix A, p. 9)

IB, pp. 9-10) The table below illustrates the decline in capital costs by comparing several cost of equity indicators from Docket No. 09-0319 with those established in the record of the current proceeding.

Cost of Equity Indicator	Docket No. 09-0319	Docket No. 11-0767	Sources[4]
30-year T-bond yield	4.13%	3.03%	Order, p. 95. Staff Ex.6.0, Sch. 6.9.
A-rated Utility bond yield	5.90%	4.40%	IIWC/FEA Ex. 1.2.
Baa-rated Utility bond yield	6.26%	5.07%	IIWC/FEA Ex. 1.2.
Implied 20-year forward Treasury rate in 10 years	4.54%	3.61%	Order, p. 94. Staff Ex. 6.0, p. 18.
Interest rate on IAWC debt issuance	6.00%[5]	5.50%[6]	Order, p. 88. Staff Ex. 6.0 – Sch. 6.3 - REVISED

IAWC argues that Staff's use of a non-water utility sample is not appropriate for determining the cost of common equity for the Company. IAWC also criticizes Staff's Water sample for excluding American Water Works and SJW Corp. (IAWC IB, p. 86) However, as explained in the Initial Brief, Staff did a thorough risk analysis to ensure

[4] "Order" refers to the final order issued in Docket No. 09-0319 on April 13, 2010.
[5] Series issued 12/4/09, line 16 of Staff Schedule 6.3 – REVISED.
[6] Series project to be issued 11/15/12, line 11 of Staff Schedule 6.3 – REVISED.

that the Water and Utility samples were comparable to IAWC and appropriate for determining the investor-required return on common equity for IAWC. (Staff IB, pp. 40-44) American Water Works and SJW Corp. were excluded from Staff's Water sample because the necessary data was not available on the date on which Staff performed its cost of common equity analysis. (Staff Ex. 14.0, p. 10)

IAWC continues to argue that the constant growth DCF model is appropriate to determine the cost of common equity for mature public utility companies, such as water utilities. (IAWC IB, pp. 83-84) As Staff discussed in its Initial Brief, Ms. Ahern did not demonstrate the sustainability of the analyst growth rates that she employed in her constant growth DCF analysis. Conversely, Staff did demonstrate that Ms. Ahern's growth rates are not sustainable over the long-term. (Staff IB, pp. 52-53) Consequently, IAWC's constant growth DCF analysis should be rejected.

The Company argues against the use of spot 30-year Treasury bond yields as the risk-free rate and for the use of the empirical Capital Asset Pricing Model ("ECAPM"). As Staff has explained, T-bond yields reflect market forces, while forecasts do not. T-bond yields reflect the return investors are willing to accept in the market. The Commission should follow the Order in Docket No. 09-0319 and rule in favor of using current T-bond yields as the risk-free rate and reject use of the ECAPM analysis. (Staff IB, pp. 47-50)

V. RATE DESIGN AND TARIFF TERMS AND CONDITIONS

A. Contested Issues

1. Zone 1-Chicago Metro Consolidation

IIWC/FEA disagree with Staff's and the Company's recommendation to consolidate Zone 1 and Chicago Metro Water. IIWC/FEA argues that the proposal to consolidate fails to recognize that the distribution network for each district (division) is distinct to that geographical region and costs to provide water service should be recovered individually by service territory. IIWC/FEA also argues that the proposal to consolidate ignores the differences in rate base investment in each district and the differences in non-production related cost of providing service in each non-interconnected district. Finally, IIWC/FEA argues that the proposal to consolidate fails to recognize the cross-subsidies being created and ignores traditional cost of service principle and the concept of cost-causation. (IIWC/FEA IB, p. 25) For the reasons discussed below, Staff disagrees with IIWC/FEA and recommends the Commission consolidate the Zone 1 and Chicago Metro Water divisions.

Contrary to IIWC/FEA's assertion, the proposal to consolidate does not ignore the differences between each district. Rather, IIWC/FEA's arguments against the consolidation ignore the similarity in cost of service that exists in Zone 1 despite the diversity of the service areas that have been consolidated into Zone 1. Currently, Zone 1 consists of many consolidated small water districts that span the state from Cairo to South Beloit. In Docket No. 09-0319, the Final Order notes the Company's explanation that:

> [G]enerally, the costs the Company incurs in providing service are similar regardless of where the customers are located. According to IAWC,

> purchasing, installing, and reading meters, billing customers, and other customer-related costs generally do not vary significantly within Zone 1. (Order, Docket No. 09-0319, April 13, 2010, p. 159)

Furthermore, IIWC/FEA's position fails to consider that in past rate cases the Commission has supported consolidation and, in fact, has approved consolidation of rate districts and movement toward Single Tariff Pricing for IAWC in several dockets including Docket Nos. 92-0116, 95-0076, 97-0102, 00-0340, and most recently, in Docket Nos. 07-0507 and 09-0319.

The Company's consolidation proposal to include the Chicago Metro Water district with Zone 1 is: (1) supported on the basis of bill impacts; (2) undermines IIWC/FEA witness Mr. Collins' belief that the distribution network for each district (division) is distinct to that geographical region and costs to provide water service should be recovered individually by service territory; (3) allows the utility to spread out capital improvement costs over a larger customer base thereby mitigating potential rate shock when large improvement projects need to be made; and (4) is consistent with the Commission's Orders in prior rate cases. Thus, the Commission should approve the Company's proposal to consolidate Zone 1 with the Chicago Metro Water district.

2. Customer Charge Calculation Methodology

The Company's proposed Customer Charge calculation methodology is inappropriate because it recovers through Customer Charges more than 100% of customer costs. The Company's methodology would produce total revenues from Customer Charges that exceed customer costs by $3.3 million. This happens because the Company applies to meter sizes larger than 5/8" the percentage increase for 5/8"

rather than the American Water Works Association ("AWWA") ratio recommendations for meter sizes larger than 5/8".

The Company defends this erroneous result by misapplying the Commission's policy to recover a greater portion of fixed costs through customer charges. (IAWC IB, pp. 99-100) The Company cites the Final Order from Docket No. 07-0507 (July 30, 2008, p. 122) where the Commission requested IAWC to "consider proposing rates whereby a greater portion of its fixed costs will be recovered through the customer charge for each rate class." The Company also cites the Final Order from Docket No. 09-0319 (April 13, 2010, p. 170) where the Commission stated:

> From a rate design perspective, all other things being equal, the Commission believes it is preferable for fixed costs to be recovered through fixed charges, and for variable costs to be recovered through variable charges such as usage charges.

However, the Company's rate design proposal goes far beyond these directives because $3.3 million of variable costs would be recovered through fixed charges. Therefore, the Commission should approve Staff's recommended customer charge calculation methodology so that no more than the full customer cost recovery is attained by the Company.

The Company's proposal also includes three different Customer Charges for 5/8" meter residential customers in the proposed consolidated group of Zone 1 and Chicago Metro Water. Zone 1 5/8" meter residential customers would incur an $18 per month Customer Charge, Chicago Metro 5/8" meter customers would incur a $17 per month Customer Charge and South Beloit Customers 5/8" meter would incur a $14 per month Customer Charge under IAWC's proposal. Since these consolidated customers face

the same set of costs, the reasonable approach is to develop a single set of rates that apply to all customers within the consolidated territory as Staff proposes rather than charging them different rates.

Staff proposes that the Commission approve Staff's recommended uniform Customer Charges for all of IAWC's ratepayers within the proposed Zone 1-Chicago Metro Water consolidated district which follow more closely the Commission's directives from the prior two rate cases. Staff's proposal would: (1) recover 99.9% of all customer costs; (2) apply the concept of uniformity and gradualism to ratepayers of various meter sizes; and (3) conform to AWWA meter ratio recommendations for meter sizes larger than 5/8". Staff's rate design strikes the appropriate balance between fixed cost recovery and variable cost recovery and should be approved by the Commission. Under Staff's proposal, 99.9% of fixed customer costs will be recovered through the Customer Charge and all non-production related costs will be recovered through the Usage Charge.

3. Proposed Usage Charges

The Company criticizes Staff's proposed Usage Charges. (IAWC IB, pp. 102-103) The primary difference between the Company's and Staff's Usage Charge recommendation is in the share of total revenue to be recovered through the Usage Charge. As discussed earlier, the Company's Usage Charge proposals are lower than Staff's due to the inappropriate recovery of $3.3 million dollars of variable costs through IAWC's proposed Customer Charges. In contrast, Staff's Usage Charge proposals are set to recover all non-production related costs through this charge.

The Company criticizes Staff's proposed Usage Charge approach because Staff's proposed rates for the third and fourth block are more than twice the overall average increase of 18.42% the Company has proposed and would result in rate shock. (IAWC IB, p.103) However, Staff's proposed increases are necessary to properly recover the non-production costs. (Staff Ex. 12.0, p. 11) While IAWC's rate design proposal appears to result in a lower increase for Other Water Utility revenue (18.42%) and Industrial revenue (23.5%) (IAWC Ex. 11.03R, p. 2) than what Staff proposes, those lower increases are illusory because they reflect recovery of an artificially low amount of non-production costs recovered through the Usage Charge. Moreover, it is incorrect to dismiss Staff's proposed rate design based on the Company's assertion that it would result in rate shock primarily because the increases cited by IAWC are based upon the Company's proposed revenue requirement, which is significantly higher than Staff's proposed revenue requirement. Specifically, the Company is proposing a revenue requirement percentage increase that is more than 100% higher than the revenue requirement percentage increase proposed by Staff. That is, IAWC proposes a total Company revenue increase of 16.21% (IAWC Ex. 5.01SR, p. 1) versus the Staff proposed 7.66% revenue increase. (Staff IB ZN, Appendix A, p. 1; Staff IB LC, appendix A, p. 1; Staff IB PK, Appendix A, p. 1; Staff IB CS, Appendix A, p.1; and Staff IB CW, Appendix A, p.1) If the Commission adopts a revenue requirement closer to Staff's proposal and Staff's proposed rate design, the resulting rate increase for Other Water Utility and Industrial classes would be far less than that projected by IAWC.

The Commission should approve Staff's proposed Usage Charge approach because it: (1) recovers all non-production related costs; (2) sends appropriate price

signals to users of the largest volume of water; and (3) allows rate payers to better control the amount of their monthly bills by conserving water.

4. Chicago Metro Public Fire Protection Charges

If the Commission does not approve the consolidation of Zone 1 with Chicago Metro Water, the Company proposes to recover Public Fire Protection revenues at an amount of less than 100% of the cost to serve Chicago Metro Water customers. (IAWC IB, p. 104) Staff disagrees and proposes Public Fire Protection Charges that would recover 100% of the cost to serve Chicago Metro Water customers. (Staff Ex. 12.0, pp. 12-13)

Section 9-223(a) of the Public Utilities Act ("Act"), states:

> Any fire protection charge imposed shall reflect the costs associated with providing fire protection service for each municipality or fire protection district.

The Company's proposed rates would recover an amount that is $9,568 short of the full cost of service.

Staff has proposed that if the consolidation of Zone 1 and Chicago Metro Water is not approved by the Commission, the Company's Public Fire Protection charges should be increased by 0.22% so that the $9,568 deficit can be fully recovered. Staff's recommendation is consistent with Section 9-223(a) of the Act and should be approved by the Commission.

5. Lincoln Public Fire Protection Charges

IAWC proposes to increase Public Fire Protection Charges for the Lincoln district by 53.8% so that the full cost of service will be recovered from these ratepayers. (IAWC IB p. 105).

Staff notes that the Company's proposed 53.8% sudden increase in the Public Fire Protection Charge would ignore the concept of gradualism and that the Commission should consider the bill impacts on these ratepayers when making a decision as to where to set this rate. Staff recommends a more gradual approach to recovering full cost of service by recommending that the Commission approve a 27% increase to Lincoln Public Fire Charges to mitigate the bill impact to customers for this charge in this district. (Staff Ex. 12.0, p. 14)

The Company argues that Section 9-223(a) of the Act requires fire protection charges to reflect the costs associated with providing fire protection and does not provide any exceptions. (IAWC IB, p. 105) Staff would first note that the Company's argument here regarding Lincoln Fire Protection Charges contradicts the Company's position regarding Chicago Metro's Fire Protection Charges. Staff is aware that there is no exception in the statutory language but it is also cognizant of the heightened concern expressed by the Commission on high bill impacts particularly in more recent water rate case orders (Docket Nos. 11-0059/11-0141/11-0142 (Cons.)) Staff's recommendation provides an alternative option for the Commission to consider should it be interested in mitigating the bill impacts to Lincoln customers. Staff further recommends that, to be consistent with Section 9-223(a) of the Act and the principle of gradualism, the

Commission direct the Company to analyze the bill impacts of increasing Public Fire Protection revenues the rest of the way to full cost of service for the Lincoln tariff group in its next rate case. (Staff Ex. 4.0, pp. 47-48)

VI. PROPOSED RIDER

A. REVENUE ADJUSTMENT CLAUSE RIDER ("RAC")

The Commission should reject the Company's proposed Revenue Adjustment Clause ("RAC"). As explained more fully in Staff's Initial Brief, the Company has not provided a sound basis for the Commission to adopt the proposed RAC. (Staff IB, pp. 72-74)

The Company argues that the Commission should approve the proposed RAC because the Commission approved Rider VBA (volume balancing adjustment) for Peoples Gas and North Shore Gas. (IAWC IB, pp. 111-112) IAWC refers to Docket Nos. 07-0241/0242 and 11-0280/0281, which includes Rider VBA, as the Commission's first introduction to decoupling mechanisms. However, Rider VBA has been approved for only one consolidated gas docket (North Shore Gas Company and the Peoples Gas Light & Coke Company). A need has not been shown to extend a decoupling mechanism to other gas utilities or to other utility industries within Illinois. (Staff Ex. 13.0, p. 10)

The Company argues that the Commission should approve the proposed RAC because the traditional ratemaking model fails when the annual water sales volume declines. (IAWC IB, p. 109) However, the Company's argument fails to consider that sales volumes fluctuate both up and down over time. The Company failed to show that volatility in its sales volumes is beyond what it has experienced in the past or why a

RAC is needed now when the Company has been able to operate without a RAC in the past. (Staff Ex. 13.0, pp. 2-3) Contrary to what the Company implies, Staff is not opposed to the RAC simply because it is something new. (IAWC IB, p.114) Rather, Staff recommends the Commission reject the proposed RAC because the Company failed to show that it is needed.

IAWC asserts that the RAC does not reduce the incentive to control costs. (IAWC IB, p. 115) However, the evidence contradicts the Company's assertion. The proposed RAC would undermine the Company's incentive to control costs because the RAC would guarantee recovery of the Company's revenue requirement regardless of whether any cost reduction is achieved. (Staff Ex. 13.0, p. 5)

IAWC also asserts that the RAC does not discourage conservation. (IAWC IB, pp. 115-116) However, the implementation of the RAC will not allow customers to see the benefit of a lower water bill if they conserve water. The steps toward conservation that may be taken by a customer will not provide a benefit to their budget if they cannot realize a price benefit from the conservation. The RAC should not be implemented as it would force customers to pay more for reduced usage that results from their conservation efforts to help the environment or better manage their bills. (Staff Ex. 13.0, p. 4) The RAC would undermine the incentive to conserve which, in turn, jeopardizes the benefits to society that result from that conservation. (Staff Ex. 5.0, p. 8)

The AG discusses an automatic assessment of the RAC surcharge (or credit) upon the filing of an information sheet. The AG states in its Initial Brief that it is

inappropriate to expand the list of automatic rate adjustments and references section 8-306(c) of the Public Utilities Act ("PUA"). (AG IB, pp. 62-63) Although Staff does not recommend the approval of a RAC, if the Commission does approve a RAC, an information sheet will be necessary. The PUA does not specifically prohibit the use of an information sheet for filings other than a purchased water or sewer surcharge or qualifying infrastructure plant surcharge. Additionally, the Company states in its Initial Brief that, "The Company will then file with the Commission on an annual basis a *request* to issue a refund to customers or to collect a surcharge, as the case may be, reflecting that difference." (IAWC IB, p. 108) Staff will review the information sheet that is filed each year if the RAC is approved.

The Company compares its request for Rider RAC to the Commission's approval of a pilot, and then permanent, gas decoupling rider for The Peoples Gas Light and Coke Company and North Shore Gas Company (Rider VBA). (IAWC IB, pp. 111-112) Yet, the Company does not even acknowledge in its Initial Brief that it contested Staff's reasonable recommendation to include in Rider RAC an internal audit requirement that existed in both the pilot and permanent versions in Rider VBA. Should the Commission approve Rider RAC over Staff and intervenor recommendations, Staff's internal audit requirement recommendation is appropriate, consistent with various Commission approved riders including Rider VBA, and should therefore be approved by the Commission. (Staff IB, pp. 75-77)

VII. AFFILIATED INTERESTS

A. Introduction

The portion of IAWC's initial brief ("IB") addressing the affiliate issues is an artful piece of misdirection and obfuscation. IAWC IB, at 120-133. IAWC asserts that the facts are largely undisputed, but then argues and misinterprets the facts that underlie each and every recommendation made by Staff witness David Sackett. The most obvious red-herring featured in IAWC's IB is an argument based on some unidentified, unarticulated Staff "agency theory." IAWC argues that "Staff's claims are predicated on an 'agency' theory." *Id*., at 120.[7] However, Mr. Sackett repeatedly testified that he was using the term "agency" as a layman, which hardly predicates a position on that or any other unidentified theory. In fact, the first time the concept of an "agency theory" was raised during the course of the proceeding was not by Staff, but by Company witness Ms. Teasley. *See* IAWC Ex. 1.00R at 2, 4-5. To state that Mr. Sackett's recommendations are predicated on an "agency theory" mischaracterizes his testimony and Staff's position.

IAWC cites agency case law for the proposition that "[t]here is nothing unusual in any person or corporation serving two principals in a given transaction where the services to each are consistent with his duty to each and the interest of neither is disparaged." *Id*., at 122. IAWC utterly, or purposefully, misses the point. Staff is not concerned with the fact that AWWSC employees (or agents) have two principals (IAWC or AWR) or whether these employees' service is consistent with the interests of IAWC or AWR. Staff is concerned with whether the interactions between these employees

[7] *See Illinois Assoc. of Remittance Agents v. Powell*, 122 Ill. App. 2d 322, 328-29 (4th Dist. 1970).

violate the Affiliated Interest Agreements (AIAs) between the parties and Section 7-101 of the Act (220 ILCS 5/7-101). IAWC's attempt to confuse the issues by arguing against a theory that was not articulated by Staff, but by the Company itself, is merely an attempt to bury the real issues in this proceeding.

B. Staff's Recommendations Regarding Section 7-101 of the Public Utilities Act Should be Adopted

Despite IAWC's claims to the contrary, the evidence provided in the record in this proceeding is more than sufficient to support each fact and legal argument presented by Staff regarding the Company's possible violation of Section 7-101 of the Act. While IAWC claims that the facts in this case are largely undisputed, it is clear that a dispute[8] does indeed exist between the parties as to both the facts of the case, and the interpretation of those facts.

C. IAWC Section 7-101 Violations

IAWC attempts to narrow the possible Section 7-101 violations at issue to two "practices" - "transferring calls to AWR" and "noting on service orders whether the customer has a line protection program." (IAWC IB, p. 120) However, cost-shifting and the improper provision of customer information are also part of the basis for Staff's recommendations. Any of these practices alone constitutes a violation of the Act.

D. Staff's Recommendations are Within the Commission's Discretion

Staff's recommendations lay firmly within the purview of the authority of the Commission. Staff does not attempt to regulate the price or offering of AWR products.

[8] Staff notes that whether, at the time of Mr. Sackett's February 16, 2012 visit to Alton, Illinois, AWWSC personnel could see IAWC ratepayer's status of AWR products is still open to debate. IAWC comments that Staff witness Sackett only gave IAWC two days notice and draws no conclusion from that comment. (IAWC IB, p. 133) Staff is at a loss to explain what the relationship of the notice given to site visit has to do with what Mr. Sackett saw at the visit.

Staff simply asks the Commission to regulate the actions of IAWC in the performance of its duties under the Act and the actions of AWWSC in the performance of its duties under the Commission-approved AIA, *including actions which affect the charges levied to IAWC under that agreement*. The Commission not only has the prerogative to investigate the service company's operations, but, since the rates charged by that service company to the utility include a portion of all costs not assigned or allocated to other parties, the Commission has an *obligation* under the Act to ensure that those charges are just and reasonable, and that the utility is not subsidizing third parties. Therefore, any or all of the service company's interactions may be properly before the Commission if they affect IAWC charges. While IAWC appears to have the luxury to sign an agreement and then walked away from its oversight responsibilities, the Commission has no such luxury.

IAWC attempts to twist the way that Mr. Sackett uses the term agency to imply something that he did not and does not intend. (IAWC IB, pp. 120-122) When AWWSC interacts with parties other than IAWC, the actions of AWWSC are very much the business of IAWC, Staff and the Commission because it is a service company and all costs not allocated to other parties are allocated to IAWC. In other words, because actions of AWWSC when interacting with AWR and other third parties affect charges to IAWC under the AIA, the relationship between those parties continues to be within the Commission's purview.

The Company's attempt to show that an "IAWC–AWR" agency relationship is required (IAWC IB, p. 121) does not bolster their argument that violations of Section 7-101 did not take place. It is sufficient that AWWSC is a service company, providing

services to both IAWC and AWR, and as such, it must not act in a manner that is prejudicial to IAWC when dealing with AWR. An agency relationship between IAWC and AWR is not required for the corporate arrangement to cease to be in the public interest. The relationship between IAWC and AWWSC, whether an agency or not, is sufficient to raise questions regarding the actions of AWWSC. If AWWSC employees, acting on behalf (or as agents of IAWC), perform services on behalf of another entity (AWR), then the Commission should investigate to see if there are violations of the Act, or of Commissioned approved agreements or inappropriate cost recovery in this rate case.

From a *services* standpoint, it only matters what services AWWSC provides to AWR *while functioning as an apparent agent of IAWC*. However, from a *cost* standpoint, AWWSC's services to AWR and the charges to AWR do affect charges to IAWC. It is therefore most certainly within the purview of the Commission to know what those services are and whether the charges to IAWC contain any costs from AWR or any other affiliate.

In other words, even accepting IAWC's characterization of Staff's position as an "agency theory," the case cited by IAWC regarding double-agency does not support its position, but rather, undermines the IAWC position. IAWC cites *Illinois Assoc. of Remittance Agents v. Powell*, 122 Ill. App. 2d 322, 328-29 (4th Dist. 1970) for the proposition that "[t]here is nothing unusual in any person or corporation serving two principals in a given transaction where the services to each are consistent with his duty *to each and the interest of neither is disparaged*" (emphasis added). It is quite a stretch, however, for IAWC to claim that the interactions of AWWSC with AWR outlined in

Staff's Initial Brief, regarding the subsidization of AWR by IAWC via AWWSC are "consistent with" AWWSC's duty to IAWC and that IAWC's interest is "not disparaged." As explained in Staff's Initial Brief, "[b]ecause AWWSC has decided to charge phone costs in a different manner than it incurs charges from the phone company, costs are shifted from other affiliates to IAWC. AWWSC incurs charges from the phone company based upon the duration of the calls. [IAWC response to Staff DR DAS 7.02b, Staff Ex. 15.0, Attachment J, p. 1] However, despite this, AWWSC has developed two alternate ways to allocate those costs to its affiliates." (Staff IB, p. 88) Staff indicated that IAWC was subsidizing AWR because the services that AWR receives from IAWC has a value which is "greater than the amount paid for those services (which is nothing)." (*Id*. p. 85) Thus, Staff concludes that as a direct result, "IAWC ratepayers are currently paying and will continue to pay for costs that should have been assigned to AWR." (*Id*. p. 79) This subsidization violates the Commission's express prohibition that "no costs from serving these other parties are passed on the IAWC." (Staff Ex. 7.0, Attachment A p. 12) It is abundantly clear that the interests of IAWC customers are indeed disparaged by the actions and interactions of these affiliates and the Company itself.

IAWC claims that the Commission has approved the "corporate arrangement" of which Mr. Sackett complains." (IAWC IB, p, 122) However, Staff notes that when the Commission re-approved this arrangement in 2004, it had declined to approve the Company's attempt to request that IAWC provide support to AWR just two years earlier. And the Commission was unaware of the various arrangements that AWWSC made with AWR, because those agreements did not go into effect until 2007, three years after

the Commission gave its conditional re-approval.[9] The Commission approval of this arrangement does not grant IAWC immunity from its effects.

IAWC attempts to narrowly define the Commission authority regarding affiliates, citing its decision in Docket No. 11-0046. (IAWC IB, p. 123) It is true that the Commission has no interest in the actions of those affiliates which have no connection with the regulated utility. However, when affiliates interact with a service company that also serves regulated affiliates, those affiliates are intrinsically linked to the utilities. The Commission has acted on this connection between affiliates in past dockets. (Staff IB, pp. 84-86)

It is apparent that IAWC misses the point of the Nicor Decision. In Nicor, the Commission asserted that it *does* have control over the actions of an affiliate via the agreement that it approves.[10] In Nicor, the Commission also required that the *service company* not solicit ratepayers at any time *during* calls *made to the utility*. The Commission expressly denied them the right to make such assistance on behalf of an affiliate or transfers to other third parties.

> Accordingly, regarding the NG Solicitations, the Commission directs NG to cease allowing its own call center personnel to solicit the services and products of NG's affiliates during customer calls. **With respect to the NG Solicitations, NG must also cease permitting its moving calls to be handled by the personnel of any affiliate that solicits the services and products of NG's affiliates during customer calls.** Therefore, Staff's recommended subsection 2.2(e) of the proposed OA is approved and NG's recommended text is disapproved.
>
> (Order, Docket No. 11-0046, December 7, 2011, p. 72, emphasis added)

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[9] The Commission-approved agreement included conditions regarding other agreements. (Staff Ex. 15.0, pp. 8-9) Additionally, the Commission approved this agreement in part due to Staff testimony that (*Id*, pp. 7-8)

[10] The Commission can even go so far as to investigate and disapprove such an agreement.

While the Commission does not have *direct* authority over the actions of an unregulated affiliate; it has the authority to allow or disallow any interaction between the regulated utility and the unregulated affiliate, if the relationship works to the detriment of ratepayers. If the affiliate wants to support the utility, it must abide by the Commission's rules.[11] Consequently, for all of the reasons articulated above, the Commission has authority to implement all of the actions Staff recommends regarding affiliate issues.

E. AWWSC Call Center

IAWC claims that "AWWSC Operates the Call Center in a Manner that Ensures Compliance with Illinois Law and Commission Orders, and Prevents Subsidization of AWR." (IAWC IB, p. 125) The fact of the matter is that this IAWC unsupported claim is wrong. IAWC has violated both Section 7-101 and Commission Orders by providing assistance to AWR. (Staff IB, pp. 97-100) Second, IAWC has subsidized AWR by allowing it to shift costs to IAWC via AWWSC. (Staff IB, pp. 86-97)

Staff has provided evidence and arguments clearly demonstrating that IAWC has historically subsidized AWR. (Staff IB, pp. 90-91 and 95) As it pertains to the current proceeding, Staff believes that each of the subsidizations in the past have continued into the test year.

In this case, the phone charges from AWWSC to IAWC are based on historic phone charges, which include rates that are greater than they should be due to the methods chosen to bill AWR and each regulated utility. According to IAWC witness Ms. Cooper, the budgeted amounts for the test year are based on "historical [charges] and any known changes that are anticipated." (Tr. (May 15, 2012), at 171)

[11] Staff also notes that it has never attempted to assert that the Commission could order AWR to stop offering WLPP, despite the implication by IAWC to this effect. (IAWC IB, p. 123)

Despite the fact that AWR has assumed payment of portions of its direct charges and the fact that AWWSC charges from the phone company have been reduced by the amount that was being billed to AWR for the use of its toll-free number, there are other charges associated with CCAP/SLAP which were part of the charges billed to regulated affiliates as part of their normal portion of the phone charges. (Staff IB, pp. 90-91) While the CCAP/SLAP program no longer continues, test year charges likely include these costs; IAWC has failed to present any evidence demonstrating that AWWSC removed these inappropriate charges that were shifted to regulated affiliates including IAWC. IAWC ratepayers should not bear the burden of these costs.

Regarding IAWC's implication that the joint sharing of facilities at Alton reduces costs to the IAWC ratepayers, IAWC again misrepresents Mr. Sackett's discovery responses and testimony by claiming that he conceded something in discovery and then attempted to back away from his position under cross-examination.

> In fact, he concurs that sharing the costs of the call center *decreases* costs allocated to IAWC ratepayers. (IAWC Cross Ex. 1 (IAWC-ICC 1.49).) [While Mr. Sackett tried to backtrack under cross-examination, he conceded in discovery responses that having IAWC and AWR share some of the costs of the call center actually decreases costs to IAWC. (Tr. 514; IAWC Cross Ex. 1 (IAWC-ICC 1.49).)]
> (IAWC IB, p. 125, fn. 22)

IAWC misrepresents Mr. Sackett's response in discovery to mean the *opposite* of what he clearly states.

> Request IAWC – ICC 1.49
> At line 353, Mr. Sackett states: "[B]ecause AWR shares costs of the facility in Alton, all costs associated with that joint facility that are not assigned or allocated to AWR remain in the pool and are allocated to other parties including IAWC." All other things being equal, if AWR maintained a separate call center and no costs of the Alton call center were assigned or allocated to it, how does Mr. Sackett expect this would affect the level of Alton call center costs allocated to IAWC?

Response
Mr. Sackett is not an accountant but his general understanding is that the amount of the costs to AWWSC for running its call center would decrease. The allocation percentage to IAWC would increase. *The net effect on the level of call center costs allocated to IAWC is unknown*.

(IAWC Cross Ex. 1 p. 76)

When the question was put clearly and directly to Mr. Sackett on cross examination, Mr. Sackett did not backtrack but clearly disagreed with the proposition.

Like IAWC, Nicor Gas also asserted that jointly sharing facilities with an affiliate would reduce costs for ratepayers, because the affiliates would bear a portion of the fixed costs. (Order, Docket No. 11-0046, December 7, 2011, p. 44) However, this reduction was considered insignificant and immaterial by the Commission in its decision given the harm done to the public interest by actions pursuant to that agreement. (Order, Docket No. 11-0046, December 7, 2011, pp. 72-75) Like Nicor Gas, IAWC attempts to deflect the focus from their wrongdoing and contend that since the net result of their activities is positive then their actions must be in accordance with the law.

IAWC claims that Mr. Sackett's recommendation that AWWSC CSRs instruct ratepayers seeking information about AWR that they cannot provide such information would be a "potentially expensive solution." (IAWC IB, p. 126) The number of transfers in 2011 was less than 3000. IAWC represents about 10% of ratepayers that AWWSC served. One could deduce that approximately 300 of these transfers are IAWC ratepayers. However, IAWC claims that the "vast majority" of these transfers are from customers in affiliated states where the CPP amounts are shown on the utility bill." (IAWC response to Staff DR DAS7.05d – Staff Ex. 15.0, Attachment F, p. 1) Therefore, the number of customer that need to be corrected each year is significantly less that

300. The "expensive" argument by IAWC is *de minimus*; moreover it is in keeping with the Commission's directive that IAWC should not lend its assistance to WLPP and AWR. Correcting a few hundred confused customers will also help prevent these types of calls from re-occurring.

The Company's assertion that CSR's transfer of calls to AWR is not a violation because the CSRs utilitize "information that is readily available" is not an excuse. AWWSC designed its phone system with the ability to transfer to only one provider – AWR. AWWSC put only one supplier's information in its computer systems – AWR. IAWC could use the same rationale to justify solicitation for AWR and billing for the service on the utility bill. These are also conveniences to the customer.

IAWC asserts that Mr. Sackett's premise is completely at odds with keeping ratepayer assets from supporting non-utility business. (IAWC IB, p. 127) This is wrong. Rather, it is consistent with his premise that IAWC should lend neither its name nor other assistance to AWR/AWWSC. In addition, when IAWC makes those transfers, without letting the ratepayer know that they are being transferred to someone outside of IAWC, it inherently lends its name and endorsement to this product. Such an endorsement was specifically rejected in Docket No. 02-0517 (discussed below). IAWC implies that good customer service requires that IAWC and AWWSC violate the Commission's directive. (IAWC IB, p. 127) Disregarding the Commission's directive is not a viable option for them to take.

E. IAWC Is Providing Services to AWR

IAWC points to specific services that it proposed in Docket No. 02-0517 for Commission approval to provide for AWR and then now attempts to claim that it is not

providing those services, or at least those *exact* same services. (IAWC IB, p. 127-129) However, as outlined below IAWC provides many of the same *types* of services in addition to subsidizing AWR as outlined above.

In Docket No. 02-0517, the Commission did not refuse to allow certain services; the Commission declined to approve *any* services. In that docket, one concern with the IAWC-proposed AIA was that it was open ended and would have allowed the provision of "other services" without prior Commission consideration. The Commission explained that it "will not approve the amended affiliate agreement to the extent that it would authorize IAWC and AWR to engage in an unknown number of unknown arrangements without the benefit of Commission review." (Order on rehearing, Docket No. 02-0517, September 16, 2003, p. 11) The same concern remains in the current proceeding.

1. Customer lists

IAWC claims that it does not provide customer lists to AWR and points to two of its witnesses for support. (IAWC IB, p. 128) IAWC witnesses assert that neither AWWSC nor IAWC provides information or customer lists to AWR, but is unwilling to corroborate these statements. Ms. Teasley states that IAWC does not provide such information, including customer lists. She also claims to have reviewed information that she then acknowledged she had only reviewed at a high level. Ms. Cooper claims that AWR does not get information from the CSC. Neither can say whether AWR gets information from AWW. The more important question is whether AWR gets ratepayer information from any AWW source, directly or indirectly. Given the inability of Company witnesses to demonstrate that AWW does not provide the information to AWR, Staff

believes that the Commission should not assume that AWR is not getting this information.

Although IAWC states that, "Ms. Cooper confirmed that AWWSC does not provide IAWC customer information to AWR (IAWC Ex. 15.00R, p. 7); but in fact, Ms. Cooper actually only asserts such information as it pertains to the Customer Service Center ("CSC") in which she works, and not AWWSC at large. Ms. Cooper states that: "Any information AWR has about an IAWC customer would have to come directly from the customer *or some source other than the CSC*." (IAWC Ex. 15.0R, p. 9, emphasis added) This other source is likely AWW.[12] Ms. Cooper has never been an employee of AWR so she does not know if they receive information from another corporate source. It appears that she cannot provide a definitive response. Ms. Cooper claims that she doesn't *know* of any interconnection.

> IAWC customer information is maintained in its own environment in ECIS and, as previously stated and demonstrated, contains no information on whether a customer has a protection plan or not. AWR has a customer information system called Aptify, which is separate and distinct from ECIS. Moreover, I know of no interconnection of these two customer information systems.
>
> (IAWC Ex. 15.S0R, p. 7)

Given the lack of compliance with other restrictions from Docket No. 02-0517, Staff finds the ambiguity of IAWC's position here to be, putting it charitably, troubling. Staff has made reasonable requests for information that could have alleviated its fears but these requests have either been ignored or circumvented. This requested information is either under the control of IAWC or its parent corporation. Either way, any

[12] If AWW had a mailing list of all of its regulated customers to be developed for the purpose of sending corporate information or holiday cards, such a list could have been provided to AWR. This would violate the Commission's order because that information is utility information.

restriction on this information that would preclude it from being provided to the Commission is a self-imposed restriction that could be lifted in the same manner as it was imposed, if so desired.

2. Endorsement

IAWC claims that it does not provide joint marketing letters on behalf of AWR and its warranty plans to customers that are signed by the president. (IAWC IB, p. 128) Staff, however, finds that AWWSC referrals, the shared logo and the exclusive association with AWR all constitute an endorsement. When IAWC ratepayers call the IAWC toll free number on the utility bill, they are greeted by an AWWSC employee (CSR) who answers "American Water". CSRs do not explain that they work for AWWSC, the service company. During a call while conducting utility business with ratepayers while billing the entire call to IAWC, when asked "do you have any service line warranty plans?" the CSRs claims that 'we' do have such a product. (IAWC IB, p. 126) This is an endorsement.

Additionally, since the only products and services and company about which information is available and provided is AWR, an affiliate, the exclusive nature of this association with AWWSC and IAWC is an endorsement.

3. Automatic flagging

IAWC claims that it does not provide automatic flagging of AWR ratepayers. (IAWC IB, p. 128) However, Mr. Sackett, however, testified that he saw this information coded in IAWC's portion of AWWSC's system. (IAWC Cross Ex. 1 (IAWC-ICC 1.55)) Subsequent to that visit, IAWC denied this claim and attempted to prove the contrary, by providing current screenshots. It is possible that AWWSC could have changed its

procedures after Mr. Sackett's visit. (Staff Ex. 15.0, p.23). AWWSC did cancel the CCAP/SLAP in February 2012, during the same month as that visit and right after Staff began questioning AWWSC's relationship with AWR. Regardless, Mr. Sackett's claim that many if not all services were provided is not unreasonable or unlikely. He noted many *similar* services as described above.

4. Service Order initiation

Finally, IAWC claims that it does not provide service order initiation for AWR ratepayers. (IAWC IB, p. 129) However, while IAWC technicians may not make the service order call directly, a technician instructs the customer to make that call. Furthermore, AWWSC's stated purpose of these service orders is to determine if the leak repair responsibility is AWR's. This is the decisive point. The party that determines leak repair responsibility and communicates with AWR is in fact providing a service. While, it may be somewhat unclear exactly how these services are provided, what matters is the point that IAWC clearly works with AWWSC in detecting these leaks. As Staff Witness Sackett testified in the hearing, IAWC does have an incentive to help AWR in this process. Tr. (May 16, 2012), at 505-507.

F. Staff's requests for information were appropriate and would not cause IAWC to violate the Public Utilities Act

IAWC argues that it cannot get information from its affiliate without violating the Act. (IAWC IB, p. 130) More important than whether or not IAWC has the information already in its possession, is whether IAWC can acquire this information from AWR. IAWC obtained information from ACBP by asking AWWSC, who has a contract with ACBP to get that information. (See IAWC revised response to Staff DR DAS-9.01 – Staff Ex. 15.0, Attachment N) IAWC could request that AWWSC ask AWR for this

information. However, Staff believes that it is appropriate for IAWC to request the information directly from AWR. This is a corporate matter and both companies answer to the same parent corporation. If it is in that corporation's best interest to provide information about AWR and its activities to IAWC, then it can certainly be done. Either IAWC made no attempt to get the information or they were rebuffed. In either case, IAWC has not cooperated with providing this information and Staff is able draw what it believes to be reasonable conclusions from that behavior.

IAWC equates Staff witness Sackett's argument that providing ratepayer information from the utility to an unregulated affiliate for marketing purposes is a service to a utility asking an affiliate to provide the affiliate's own business information to the Commission. (IAWC IB, p. 130) As in Docket No. 02-0517, when the Commission indicated that economic analysis of WLPP could have been provided, the Commission stated:

> Among Staff's criticisms of the WLPP is that it can not properly analyze the program and the compensation for the services provided by IAWC because neither IAWC nor AWR [any] longer has any information that sets forth an economic analysis of the program….Staff also urges the Commission to reject the WLPP because to do otherwise would encourage other utilities and their affiliates to destroy information that is pertinent to a Commission decision or simply argue that they do not know the whereabouts of the requested information. (Order on Reopening, Docket No. 02-0517, September 16, 2003, p. 14)
>
> Just as it is troubled by the open ended nature of the amended affiliate agreement, the Commission is troubled by the lack of any analysis justifying the offering of the WLPP to Illinois rate payers. Staff, CUB, and the AG are correct in their observations that the record is void of any economic or other analysis of the WLPP. Mr. Ruckman himself admits that he does not know how often the customer-owned portion of a water line fails due to normal wear and tear. Nor is he even certain that IAWC maintains records that would answer this question. In the absence of any substantive evidence demonstrating that the WLPP is properly priced or is even legitimately necessary, it is not in the public interest to allow IAWC to lend its name and

> assistance in marketing the WLPP to Illinois rate payers. The Commission acknowledges that an appropriate analysis could have been done and is not available for one reason or another, but to simply accept IAWC's assertions that the WLPP is in the pubic interest in the face of legitimate questions raised by Staff, CUB, and the AG would be a disservice to Illinois consumers and an offense to the Commission's obligations under the Act. Accordingly, the Commission finds that the WLPP has not been shown to be in the public interest and will not be approved. (*Id*., p. 16)

According to the Commission, an "appropriate analysis" would have included an economic analysis of WLPP and an analysis of the likelihood that repairs are needed. While the repair likelihood data would have come from IAWC's own records, *the economic analysis of WLPP could only have come from AWR*. And the Commission noted that an appropriate analysis "could have been done." But since it wasn't, the Commission did not approve IAWC support of WLPP. The Commission did not say that it was appropriate that IAWC did not attempt to provide information from AWR without Commission authorization which would have been a violation of the Act. The Commission understood that in order for it to make decisions about such matters, some information from affiliates will have to be provided.

G. Expansion Costs

While IAWC claims that the allowance for AWWSC's 2007 expansion is overstated by Mr. Sackett because "only a small portion of the total expansion was related to AWR's facilities" (IAWC IB, pp. 65-66), Mr. Kerckhove explained that "a small portion" equals one-third. (Tr. (May 16, 2012), at 386) Thus, about a third of the $2.8 million in costs pertained to AWR's operations. It is not possible to determine if the portion remaining in IAWC's costs belong to AWR. Some of these $2.8 million in costs are for investments that have been completely depreciated. It is unlikely that they have all been fully depreciated, which is what IAWC's recommendation to disregard them

would require. Furthermore, it is possible that the entire portion still in rates. Moreover, these costs were in the last rate case test year and therefore, are in current rates. Allowing IAWC to again recover these costs in rates amounts to an ongoing subsidy to AWWSC/AWR.

Staff Recommendations

Because AWWSC utilized allocation methodology that did not adequately charge AWR for its phone costs, Staff recommends a reduction in operating expenses of $75,000 for IAWC.

In addition, because IAWC has failed to justify the costs paid by AWR for the 2007 joint facility expansion at Alton, Illinois, Staff also recommends that the Commission reduce the depreciation expense by $10,268 in this case.

Staff recommends that the Commission order that IAWC prohibit AWWSC from referring IAWC's ratepayers to any affiliate providing non-regulated services.

Staff recommends that the Commission prohibit AWWSC and IAWC from making determinations for any affiliate regarding leak repair responsibility.

Staff recommends that the Commission open a proceeding within sixty days of the Order in this case, to review the AIA between AWWSC and IAWC to determine if it is in the still in the public interest given the disregard of compliance by both parties to that agreement. Additionally, given IAWC's failure to provide information regarding this matter in this case, which has deprived the Commission of a complete record, Staff recommends that that the Commission direct that the Company be ordered to make the necessary showing that they are in compliance with the terms of the AIA.

Furthermore, Staff recommends that the Commission consider whether imposing penalties on IAWC would be appropriate if it is found to be in violation of Section 7-101 of the Act.

Last, Staff recommends that the Commission order IAWC to demonstrate that AWR does not enjoy access to ratepayer information.

VIII. CONCLUSION

For the reasons set forth above, Staff respectfully requests that the Commission's Final Order in the instant proceeding incorporate Staff's modifications to the Company's proposed general increase in water and sewer rates as reflected in Appendix A attached hereto.

Respectfully submitted,

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